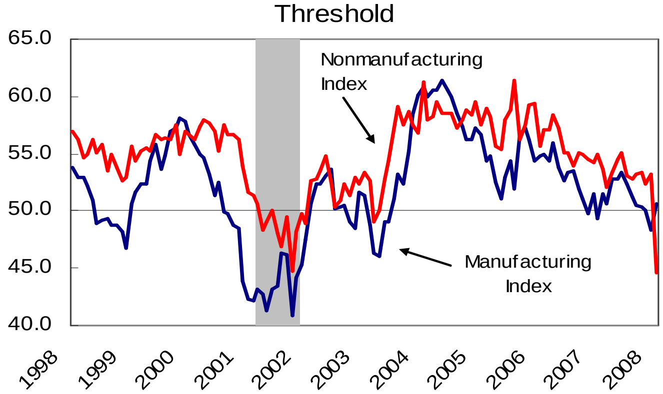
Joint Economic Committee
WEEKLY ECONOMIC DIGEST
Senator Charles E. Schumer, Chairman
Congresswoman Carolyn B. Maloney, Vice Chair
February 12, 2008

ECONOMIC NEWS

Discouraging Signs for the Economy

Institute for Supply Management (ISM) nonmanufacturing activity index plummeted in January. The ISM surveys purchasing managers in the manufacturing and nonmanufacturing sectors, asking questions such as whether output and employment are higher or lower than in the preceding month. Using survey responses ISM constructs indices of economic activity. The indices have a value below 50 when reports of business contraction outnumber those for expansion, and they have a value above fifty when results favor expansion. The nonmanufacturing index covers construction, financial services, entertainment, real estate, and retail trade. Until January, the manufacturing and nonmanufacturing indices have generally moved closely together. The results for January show a very sharp drop in the nonmanufacturing index. Some economists fear this decline may be a harbinger of a significant drop in retail sales in January. (See Chart)

Headline ISM Indices Trending Below Expansion Threshold



Note: The gray area indicates a period of recession as defined by the National Bureau of Economic Research.
Sources: Institute for Supply Management and National Bureau of Economic Research.

Initial jobless claims show sustained increase from last month. For the week ending Feb. 2, initial jobless claims were 356,000 on a seasonally adjusted basis. The 4-week moving average for initial claims rose to 335,000, an increase of 8,500 from the previous week.

Productivity growth declined in the fourth quarter. Last week's report from BLS showed that seasonally adjusted annual rates of productivity change--as measured by output per hour of all persons – fell between the third and fourth quarters of 2007. The rate of productivity growth in the business sector was 0.6%, down from 6.5% in the previous quarter. In the nonfarm business sector, productivity grew 1.8%, down from 6.0%. The lower productivity numbers this quarter reflect the drop in output, as previously reported in fourth quarter GPD figures.

IN FOCUS

Signals of a Sharp Economic Slowdown

Signals of a sharp economic slowdown have recently appeared in two economic indicators. Last week financial markets had a strong negative response to an economic report that usually does not frighten people. On Tuesday, the Institute for Supply Management (ISM) released the January value of its nonmanufacturing index (NMI), an index of economic activity based on questions such as whether output and employment were higher or lower than in the preceding month in various non-manufacturing sectors. The value of the NMI fell below 50, which indicates a contraction in the nonmanufacturing sector. What caught the attention of the markets was the size of the downward move and a noticeable change in pattern.

Usually the nonmanufacturing index moves together with ISM's purchasing manager index (PMI), which is based on a survey of manufacturing firms. But in January the NMI and PMI diverged significantly. The NMI fell sharply below 50, while the PMI moved up slightly. (See Snapshot) In the past 10 years we have only seen this kind of behavior twice – after 9/11 and at the beginning of the war in Iraq. Financial market participants apparently viewed the downward move in the NMI as a signal that domestic consumer demand has started to contract.

We can see another signal of contraction in state-level data. The Federal Reserve Bank of Philadelphia produces a set of indices that measure economic activity in each state. They summarize changes in employment, hours

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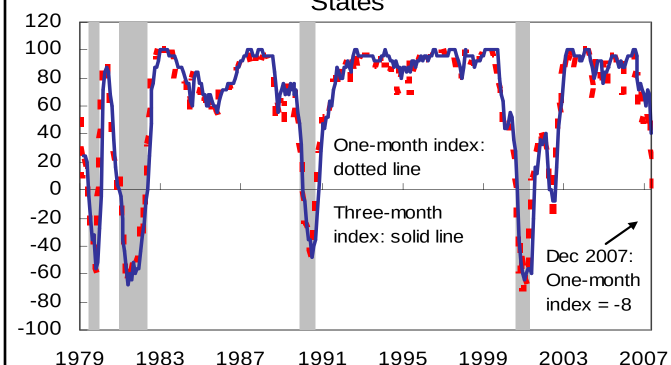
SNAPSHOT

One-Month and Three-Month Diffusion Indices for the 50 States



Note: The gray areas indicate periods of recession as defined by the National Bureau of Economic Research.
Source: Federal Reserve Bank of Philadelphia, National Bureau of Economic Research and JEC Calculations.

THE WEEK AHEAD

DAY	RELEASE
Wednesday, Feb 13	Retail Sales (January 2008) Business Inventories (December 2007)
Thursday, Feb 14	Trade Balance (December 2007)
Friday, Feb 15	Industrial Production and Capacity Utilization (January 2008)

Wednesday Feb 13th: JEC Hearing on Sovereign Wealth Funds and the US Economy

THE ECONOMY AT A GLANCE

KEY INDICATORS	MONTH			QUARTER			YEAR	
	Jan	Dec	Nov	2007 Q4	2007 Q3	2007 Q2	2007	2006
Real GDP Growth (%)	—	—	—	0.6	4.9	3.8	2.2	2.9
Unemployment (% of labor force)	4.9	5.0	4.7	4.8	4.7	4.5	4.6	4.6
Labor Productivity Growth (%)	—	—	—	1.8	6.0	2.2	1.6	1.0
Labor Compensation Growth (%)	—	—	—	3.4	3.1	3.5	3.4	3.1
CPI-U Inflation (%)	n.a.	3.7	10.0	4.3	1.9	6.0	2.9	3.2
Core CPI-U Inflation (%)	n.a.	2.4	3.7	2.5	2.5	1.9	2.3	2.5

Sources: Bureau of Economic Analysis, U.S. Department of Commerce; Bureau of Labor Statistics, U.S. Department of Labor.

Notes: Except where otherwise noted, values in the table represent percent changes at seasonally adjusted annual rates. Productivity is output per hour worked in private nonfarm businesses. The Employment Cost Index is for civilian workers in government and business. Core CPI-U inflation is the percent change in the CPI-U excluding food and energy as reported by the Bureau of Labor Statistics. The designation "n.a." denotes that data are not yet available.

IN FOCUS (Continued)

worked, the unemployment rate, and wages and salaries. Because these indices are broad measures of economic activity and because changes in economic activity are not perfectly correlated across states, the indices contain information on the direction and dispersion of economic change across the country.

One way to summarize the dispersion of contractions and expansions is through a "diffusion index" based on the Philadelphia Fed state-level indices. This diffusion index is simply the percentage of states in which the economy is expanding minus the percentage of states in which it is contracting. When economic activity is increasing in all states, the diffusion index has a value of 100. As the share of states expanding declines, so does the diffusion index. When 25 states are expanding and 25 are not, the value of the index is zero. When contracting states outnumber expanding states, the index takes on a negative value.

Large declines in the Philadelphia Fed one-month and three-month diffusion indices are strongly correlated with national economic downturns as defined by the National Bureau of Economic Research. This can be seen when the one and three-month indices are displayed against recession periods, as they are in the Snapshot. Both the Philadelphia Fed diffusion indices turned negative within two months of the start of the four recessions that occurred since 1979. The indices took on negative values and falsely signaled recession on one occasion, in 2003.

The data displayed in the Snapshot certainly suggest a rapidly spreading economic slowdown. In December 2007 both the one-month and three-month diffusion indices declined and the one-month index turned negative. Because a negative one-month dispersion index can be a false signal of recession, there is insufficient information to indicate that a recession actually is under way. But as with the decline in the NMI, the declines in the Philadelphia Fed indices are not encouraging.